

II. Government Accounting

1. Introduction

The public and private sectors both used cash accounting until the 16th century. While government accounting remained on a cash basis, the private sector developed generally accepted accounting principles (GAAP)—including accrual accounting—in response to economic pressures:⁴

- the distancing of owners and lenders from managers—driven by the development of financial markets—created a need for better and more transparent information on how well companies were managed; and
- growing competition drove a requirement for better management information on which to base decisions such as price setting.

However, the public sector environment differs from the private sector environment. Among other things: (i) government fiscal activities intentionally impact the economy, for instance, recent US tax cuts are intended to stimulate demand; (ii) government (generally) has power to create money and to coercively impose levies and taxes; (iii) government objectives are broader than those of private sector organizations and include equity, justice and poverty reduction; (iv) in many cases government not only owns an organization, but also is the major purchaser of its goods and services; and (v) governments are accountable to a wider group of stakeholders.

Furthermore, public sector activities are closely scrutinized through the following mechanisms:

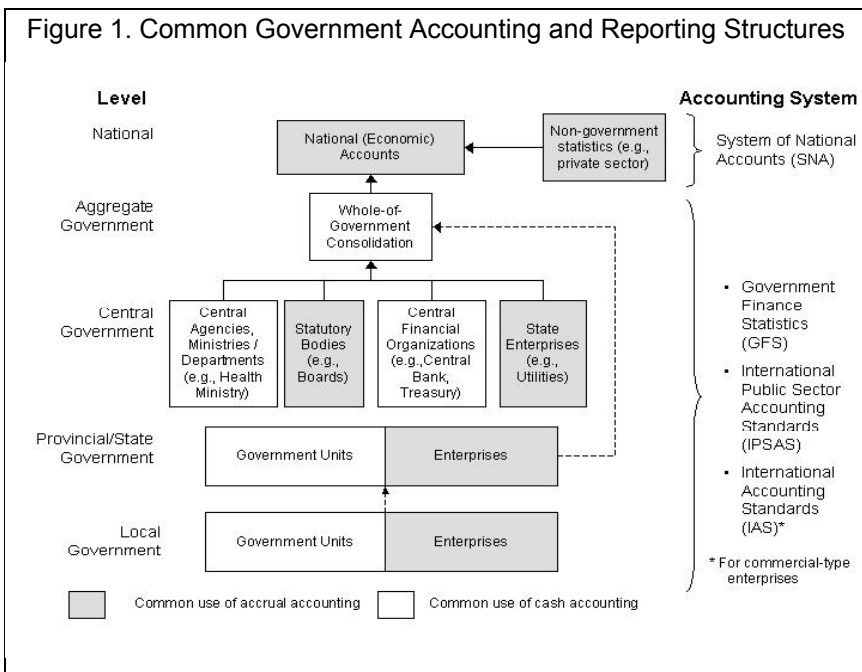
- *Budgets and Forecasts.* The executive branch generally prepares annual budgets and multi-year forecasts for scrutiny and consideration by the legislative branch.
- *Appropriations.* The legislative branch (e.g., parliament) generally authorizes the executive branch (e.g., the government) to incur expenditures.

⁴ For the purposes of this report, the term “accrual accounting” means accrual accounting within the constraints of GAAP.

- *Reports (or outturns)*. At year-end, and sometimes during the year, the executive branch generally prepares financial statements for scrutiny and consideration by the legislative branch.

Many governments that have implemented accrual accounting have not uniformly applied the accrual basis to these mechanisms. For instance, budgets may be prepared on a modified accrual accounting basis, appropriations may be made on the cash basis, and reports may be presented on the accrual basis.

This part describes accounting in the context of government structures, which are generally more complex than private sector structures. Figure 1 illustrates common government levels and sectors. Historically, budgeting and accounting methods have generally differed between levels and sectors—for instance, central government agencies might use cash accounting while provincial and local governments, state enterprises, and statutory bodies prepare accrual-based reports.



This part provides background information on government accounting. In addition to this introduction, it has the following sections. Section 2 describes cash and accrual accounting. Section 3 discusses the main international government accounting and statistical systems. The status of accrual budgeting and accounting in developed countries is described in Section 4.

2. Differences Between Cash and Accrual Accounting

This section is intended for non-technical readers—it describes cash and accrual accounting, and the differences between the two systems.

- *Cash accounting* records receipts when cash is banked and payments when cash is paid.
- *Accrual accounting* recognizes events and transactions when they occur, regardless of when cash changes hands.

Only a cash flow statement is prepared under cash accounting. Under accrual accounting—in addition to the cash flow statement—two key financial statements are presented.⁵

- *Operating Statement*: Shows the financial results of an organization's activities for a period—that is, were sufficient revenues generated to cover expenses?
- *Balance Sheet*: Shows all financial items the organization owns and owes at a certain point in time, providing insights on the organization's long-term financial sustainability.

Using a simple example, Box 1 illustrates some differences between cash and accrual accounting—the way in which pension obligations are treated is particularly informative.⁶ On one hand, cash accounting ignores the \$30 million pension obligation (in present value terms) until the pension payments are actually made, usually many years later. Con-

⁵ International accounting standards require the preparation of four primary key statements: (i) Statement of Financial Position (balance sheet); (ii) Statement of Financial Performance (operating statement, income statement or profit and loss account); (iii) Statement of Changes in Net Assets/Equity; and (iv) Cash Flow Statement.

⁶ In keeping with most government pension scheme arrangements, the example assumes that pension obligations are unfunded.

versely, accrual accounting immediately recognizes the obligation as an expense.

Box 1. A Week in the Life of a Small Government

The following example considers a week in the life of a small government. The effects of the following five transactions are shown in the financial statements below:

- a. Corporate taxpayers are required to make **tax payments** of \$100 million to the government, but only \$90 million is received. At the end of the week, \$10 million is outstanding.
- b. The government **sells fixed assets** for \$100 million. The assets had been valued at \$100 million.
- c. Government **salary payments** are made during the week. In addition to paying employees \$60 million, the government is obligated to provide for their pensions when they retire—employees earned \$30 million in future pension rights during the period.
- d. The government settles a long-running **legal dispute**. It agrees to pay \$30 million to the plaintiff in 2 months' time.
- e. All the government's borrowings are held in **foreign exchange**. The exchange rate declined by 2% during the week.

Cash accounting would report a \$130 million surplus, while the accrual operating statement shows a \$30 million deficit. The \$160 million difference arises from the fact that cash accounting ignores the pension liability (\$30 million), the asset already had a value equal to its sale price (\$100 million), the exchange rate change (\$10 million), the judgment liability (\$30 million), and the taxes to be received (\$10 million).

Accrual Accounting Information

Cash Accounting Information

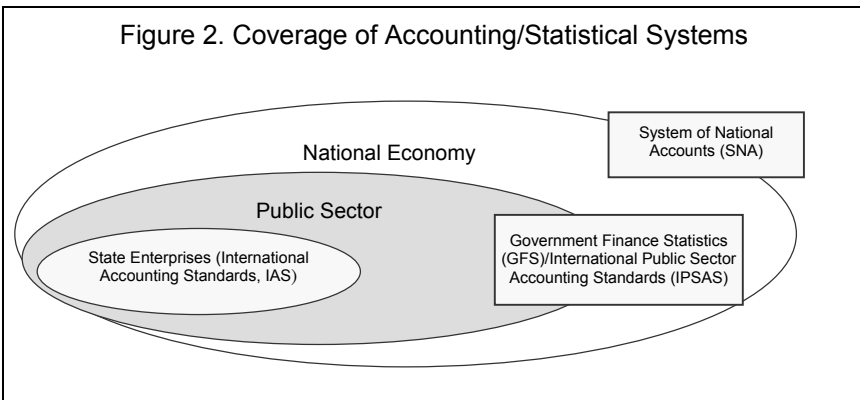
Cash Flow Statement		Operating Statement		Balance Sheet		
				Opening	Changes	Closing
Receipts		Revenues		Assets		
Taxation	a 90	Taxation	a 100	Bank	50	130
Asset sales	b 100		100	Receivables	20	a 10
		Expenses		Fixed assets	700	b -100
Payments		Personnel costs	c 90		770	40
Salaries	c -60	Foreign exchange loss	e 10	Liabilities		810
Cash Surplus	130	Litigation expense	d 30	Litigation	..	d 30
			130	Pension liability	..	c 30
Bank balance		Accrual Deficit	-30	Borrowings	500	e 10
Opening	50				500	70
Closing	180			Net Assets	270	-30
						240
				Equity and Reserves	270	-30
						240

3. Public Sector Accounting Systems

Background

Government accounting systems determine how financial and statistical information is prepared and presented. The three major international systems have slightly different purposes—Figure 2 illustrates differences in coverage (see also Figure 1 on page 4):

- The European Union (EU), International Monetary Fund (IMF), OECD, United Nations (UN) and World Bank jointly publish the System of National Accounts (SNA). It compiles aggregate financial statistics for an entire economy; government and private sector activities are combined together.
- The IMF Government Finance Statistics (GFS) is a specialized system intended to support public sector analysis. The IMF designed GFS so that government financial information could be compared across economies.
- The International Federation of Accountants (IFAC) began promulgating International Public Sector Accounting Standards (IPSAS) in 2000. They are designed for use in the preparation of general-purpose financial reports by public sector entities (individual government agencies or whole-of-government reports).



SNA, GFS and IPSAS have been developed, or radically overhauled, in the past decade—all are now accrual based.⁷ The European System of Accounts (ESA 95) also mandates accrual-based financial reporting (see page 12). The following subsections describe the three international systems.

System of National Accounts

Most recently revised in 1993, SNA comprises an integrated set of macroeconomic accounts, balance sheets and tables based on a set of internationally-agreed concepts, definitions, classifications and accounting rules. It provides an accounting framework within which economic data can be compiled and presented in a format that supports economic analysis and policy making. SNA is also a reference point for establishing standards for related statistics and harmonizing other statistical systems such as balance of payments, GFS, and money and banking statistics. Furthermore, it allows for the introduction of new accounts such as environmental accounts.

Table 1 presents an example of SNA-based balance sheets. In general, “all the [OECD] government budget and national income account data follows the guidelines of the 1993 SNA.”⁸

Developing and transitional economies will require time to introduce the revised accrual system. For example, the Philippines expects to produce SNA-compliant balance sheets in 2003.⁹ Sri Lanka expects to do likewise in 2004. The People’s Republic of China (PRC) has prepared national balance sheets since 1997, but will not publish these until compilation issues, particularly asset valuations,¹⁰ have been addressed.¹¹ ADB—together with agencies such as the IMF, UN and

⁷ In February 2003, IFAC issued a cash-based IPSAS (*Financial Reporting under the Cash Basis of Accounting*). The IPSAS had been approved in November 2002.

⁸ Perotti, Roberto. 2002. Estimating the Effects of Fiscal Policy in OECD Countries. Paper presented at the ISOM Conference, Frankfurt. 14-15 June.

⁹ Virola, Romulo A. and Estrella V. Domingo. 2001. Changing the Philippine National Accounts Series. Paper presented at the concluding workshop on RETA 5874: Rebasings and Linking of National Accounts Series, held in Bangkok, Thailand, 13-16 February.

¹⁰ Non-financial assets must be recorded at market value, but the PRC values these assets at historic cost.

¹¹ Lihua, Dong (National Bureau of Statistics). 2001. The Status of Implementation of the 1993 SNA In China. Paper presented at ADB TA No. 5874-REG: Rebasings and Linking of NAS workshop. 13-16 February. p. 3.

World Bank—is supporting DMC efforts to implement the updated SNA.¹²

Table 1. Japan: SNA-Based Balance Sheets: 1996–2000
(Billion Yen)

Item	1996	1997	1998	1999	2000
1. Non-financial assets	3,057,728	3,062,737	2,995,969	2,906,439	2,840,663
(1) Produced assets	1,259,795	1,303,989	1,295,283	1,293,646	1,304,505
a. Inventories	102,703	103,200	98,387	96,788	94,788
b. Tangible fixed assets	1,145,971	1,188,376	1,182,750	1,183,858	1,195,789
c. Intangible fixed assets	11,121	12,413	14,146	13,001	13,928
(2) Tangible non-produced assets	1,797,933	1,758,748	1,700,686	1,612,793	1,536,159
2. Financial assets	5,208,233	5,366,850	5,385,748	5,674,758	5,636,793
Of which shares	425,006	366,721	302,569	502,847	414,493
Closing assets	8,265,961	8,429,587	8,381,717	8,581,196	8,477,456
3. Liabilities	5,120,883	5,242,263	5,252,475	5,590,023	5,503,746
Of which shares	467,998	402,413	340,436	598,244	482,908
4. Net worth (national wealth)	3,145,078	3,187,324	3,129,242	2,991,174	2,973,710
Closing liabilities plus net worth	8,265,961	8,429,587	8,381,717	8,581,196	8,477,456
(cf) Historic monuments	245	263	284	303	322
Intangible non-produced assets	116	154	137	194	195

SNA = System of National Accounts.

Source: Economic and Social Research Institute. 2002. *Annual Report on 2002 National Accounts*. Cabinet Office. Government of Japan. 25 June.

Government Finance Statistics

The IMF released a revised GFS Manual in 2001 (see Box 2). In addition to English, the manual will be published in Arabic, Chinese, French, Russian and Spanish. Practical guidance is also being developed.

¹² Between 1971 and October 2002, ADB provided \$21.81 million to support 60 technical assistance (TA) projects for statistical capacity building (Pant, Bishnu D. 2002. *Statistical Capacity Building: An ADB Perspective for a Fresh Approach*. Presentation to the ADB / PARIS21 High Level Forum on Statistical Capacity Building for ASEAN Countries. Manila. 7-9 November. p. 16.) See, for instance, ADB TA No. 2875-PHI: *Institutional Strengthening of the System of National Accounts*, for \$400,000, approved on 25 September 1997. This TA culminated with a regional workshop in May 2001. Attended by 15 countries from the Asian region, the workshop examined the Philippine experience in implementing and institutionalizing SNA 1993. Individual countries presented papers on topics including preparing consolidated accounts and balance sheets.

The revised manual reflects developments in fiscal analysis. Analysts have traditionally used fiscal statistics to analyze: (i) the size of the public sector; (ii) its contribution to aggregate demand, investment, and saving; (iii) the impact of fiscal policy on the economy, including resource use, monetary conditions, and national indebtedness; (iv) the tax burden; (v) tariff protection; and (vi) the social safety net. However, analysts are increasingly interested in assessing the effectiveness of spending on poverty reduction, the sustainability of fiscal policies, net debt, net wealth, and contingent claims against government, including obligations for social security pensions.

Given these widened objectives for fiscal analysis, the revised GFS Manual has introduced the accrual basis of recording economic events. GFS concepts and principles are now harmonized with those of SNA 1993 so that government finance statistics can be used jointly with other macroeconomic statistics.

Box 2. IMF Releases Accrual-based GFS Manual

“This Manual represents a major step forward in the standards for compilation and presentation of fiscal statistics and thus takes its place as part of the worldwide effort to improve government accounting and transparency in operations. Government finance statistics are a key to fiscal analysis, and they play a vital role both in developing and monitoring sound financial programs and in conducting surveillance of economic policies.

Of particular note is that the Manual introduces accrual accounting, balance sheets and complete coverage of government economic and financial activities. Although only a few countries are currently capable of meeting the standards promulgated in this Manual, the number is increasing steadily and I hope that the trend continues. I commend the Manual to compilers and users as an important instrument in their work and urge member countries to adopt the guidelines of the Manual as the basis for compiling government finance statistics and for reporting this information to the Fund.”

Horst Köhler, IMF Managing Director
Foreword to the GFS 2001 Manual

GFS = Government Finance Statistics; IMF = International Monetary Fund

International Public Sector Accounting Standards

IFAC began issuing accrual-based IPSAS in May 2000. They are based on the private sector International Accounting Standards (IAS). Entities applying the accrual-based IPSAS must also prepare cash flow statements in accordance with IPSAS 2 *Cash Flow Statements*. IFAC has issued 20 accrual-based IPSAS (see Appendix 1).

Given their recent and ongoing development, it is not surprising that, as of December 2002, few countries directly referred to IPSAS for their public sector reporting. However, there is a trend for countries to refer to IPSAS when developing government accounting standards. For instance, in designing its government budgetary reforms, the PRC referred to IPSAS.¹³ Additionally, the Public Sector Commission of the Spanish Association for Accounting and Business Administration is preparing a conceptual framework for public entities, mostly in line with IPSAS.¹⁴ Furthermore, several international organizations have decided to implement the accrual-based IPSAS (e.g., European Commission, OECD).

Appendix 2 briefly describes selected technical issues associated with the use of accrual accounting in government, including accounting for heritage assets (e.g., monuments), infrastructure assets (e.g., highways), social insurance programs, military assets, and defining the reporting entity.

The Cash IPSAS

In February 2003, IFAC released a cash-based IPSAS (*Financial Reporting under the Cash Basis of Accounting*). It becomes effective for annual financial statements, covering periods beginning on or after 1 January 2004, when a government decides to apply the IPSAS. It has two parts:

- Part 1 specifies mandatory requirements for entities preparing cash-based financial statements, by: (i) defining the cash accounting basis; (ii) defining reporting formats; and (iii) specifying information disclosure requirements. It also addresses several specific reporting issues.
- Part 2 identifies additional accounting policies and disclosures that entities are encouraged to adopt. In particular, it provides guidance on disclosing assets, liabilities and related-party transactions. In doing so, it provides guidance for entities intending to migrate to the accrual accounting basis.

¹³ Jiwei, Lou (First Vice Minister, Ministry of Finance). 2002. Government Budgeting and Accounting Reform in China. *OECD Journal on Budgeting*, Vol 2(1). December. pp. 51–80.

¹⁴ Montesinos, Vicente. 2002. Government Budgeting and Accounting Reform in Spain. *OECD Journal on Budgeting*, Vol 2(1). December. pp. 333–354.

4. Status of Accrual Accounting and Budgeting in OECD Countries

Table 2 reviews the status of accrual accounting and budgeting in OECD member countries. It reveals that most OECD members have introduced aspects of accrual accounting and more intend to do so in future.

EU member countries are required to prepare government forecasts and financial statements in accordance with the European System of Accounts (ESA 95). ESA 95 uses an accrual-based financial reporting framework to calculate the Maastricht budget balance—the economic and budget criteria set forth in the 1992 Maastricht Treaty. This balance combines all central government departments, social security funds and local government units. However, as the balance does not consider estimated expenditure (i.e., depreciation and provisions), it might best be described as a modified accrual-based measure.¹⁵

Table 2. OECD Member Countries: Government Accounting

OECD Member	Accrual Accounting for Individual Agencies/ Departments	Consolidated Accrual Reporting	Accrual Budgeting
G7 Economies			
Canada	Since FY 2002	Since FY 2002	Yes
France	Being introduced	Some, full accrual being introduced	ESA 95. Intends to move to modified accrual basis
Germany	Cash statements supplemented with accrual information	No	ESA 95. In preparation
Italy	Yes	Yes	ESA 95. Yes
Japan	Yes	Introducing	No
United Kingdom	Since FY 2000	From FY 2006	ESA 95. Since FY 2002
United States	Since FY 1998	Since FY 1998	Some

¹⁵ IFAC. 2003. *The Modernization of Government Accounting in France: The Current Situation, the Issues and the Outlook*. New York. Public Sector Committee. p. 10.

OECD Member	Accrual Accounting for Individual Agencies/ Departments	Consolidated Accrual Reporting	Accrual Budgeting
Other Members			
Australia	Since 1995	Since 1997	Since FY 2000
Austria	No ^a	No	ESA 95. Modified accrual
Belgium	Some	No	ESA 95. Modified accrual
Czech Republic	No ^a	No	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Denmark	Some	Some	ESA 95. Is introducing full accrual budgeting
Finland	Since 1998	Since 1998	ESA 95. Yes
Greece	Some	Yes	ESA 95. Modified accrual
Hungary	Cash statements supplemented with accrual information	No	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Iceland	Since 1992	Since 1992	ESA 95. Since 1998
Ireland	Cash statements supplemented with accrual information	No	ESA 95. Modified accrual
Korea, Republic of	Is introducing full accrual accounting	No	Is introducing full accrual budgeting
Luxembourg	No ^a	No	ESA 95
Mexico	No ^a	No	No
The Netherlands	Since 1994	Introducing	ESA 95. For agencies since 1997. Is introducing full accrual budgeting
New Zealand	Since FY 1992	Since FY 1992	Since FY 1995
Norway	No ^a	No	No

OECD Member	Accrual Accounting for Individual Agencies/ Departments	Consolidated Accrual Reporting	Accrual Budgeting
Poland	Some	Some	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Portugal	Yes	No	ESA 95. Is introducing additional accrual information
Slovak Republic	No ^a	No	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Spain	Modified accrual	Modified accrual	ESA 95. Modified cash
Sweden	Since 1994	Since 1994	ESA 95. Is introducing full accrual budgeting
Switzerland	Yes	No	Is introducing full accrual budgeting
Turkey	No ^a	No	No

ESA 95 = European System of Accounts 1995; FY = Fiscal Year;
 OECD = Organisation for Economic Co-operation and Development.

- a Most countries actually use modified cash accounting (for a discussion, see IFAC. 2000. *Government Financial Reporting: Accounting Issues and Practices*. Study No. 11. New York: Public Sector Committee).

Sources: OECD. 2002. PUMA Database Reports. August. Paris; OECD. 2002. *Accrual Accounting and Budgeting: Key Issues and Recent Developments*. PUMA/SBO(2002)10. Paris; Blöndal, Jón R. and Jens Kromann Kristensen. 2002. Budgeting in the Netherlands. *OECD Journal on Budgeting*. Vol 1(3). pp. 43–80; OECD. 1998. *Public Management Developments in Austria: Update 1998*. Paris; OECD. 1999. *Focus*. 12 March; Swedish National Financial Authority (Ekonomistyrningsverket). 2001. *Accrual Accounting in Swedish Central Government*. May. Stockholm. p. 27; Montesinos, Vicente. 2002. Government Budgeting and Accounting Reform in Spain. *OECD Journal on Budgeting*. Vol 2(1). December. pp. 333–354; and Study Group on Explanatory Methods of Fiscal Position. September 2001. *The Japanese Government Balance Sheet (Preliminary trial)*. Ministry of Finance. See <http://www.mof.go.jp/english/budget/bs/zai003e.pdf> [3 January 2003].